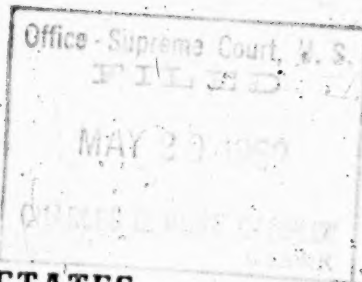


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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1952

No. 787-76

EDWIN E. HEALY AND GORDON W. HARTFIELD,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE
SECOND CIRCUIT AND BRIEF IN SUPPORT
THEREOF.

FRANK J. MAGUIRE,
Counsel for Petitioners.

JAMES H. HEFFERN,
Of Counsel.

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**PETITION FOR WRIT OF CERTIORARI TO THE
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SECOND CIRCUIT AND BRIEF IN SUPPORT
THEREOF.**

*To the Honorable Chief Justice and Associate Justices of
the Supreme Court of the United States:*

Petitioners pray that a writ of certiorari issue to review the decision of the Court of Appeals for the Second Circuit entered on February 15, 1952 reversing the determination of the Tax Court of the United States entered March 14, 1951.

Opinions Below

The opinion of the Tax Court of the United States is reported in 16 T. C. 200 and the opinion of the United States Court of Appeals is reported at 194 F. 2d 662.

Basis of Jurisdiction

Jurisdiction is invoked under USC Title 28, section 1254 (1) and section 1141 (a) of the Internal Revenue Code.

This decision of the United States Court of Appeals for the Second Circuit was entered on February 15, 1952. By Order of Robert H. Jackson, Associate Justice of this Court, dated May 12, 1952, the time for filing this petition was extended to May 29, 1952.

Statement of Matter Involved

The essential facts were stipulated in the proceeding before the Tax Court of the United States (R. 4, 5, 6, 7). The proceedings were consolidated for trial before the Tax Court and for review by the Court of Appeals.

The matter is summarized in the opinion of the Court of Appeals as follows:

"At the times pertinent here, George W. Hartfield and Edwin E. Healy were officers of the Hartfield-Healy Supply Company, Inc., a New York corporation, and each was the owner of twenty-five of the fifty-two outstanding shares of stock. In 1945 the corporation was insolvent. During that year there was paid by the corporation as salary to each of the above named officers the sum of \$30,000. Such payments were reported on the corporate tax return for that year, and were reported as income received by the recipients in their 1945 individual income tax returns, which were made on a cash basis.

"Upon later examination of the corporate return, the Commissioner found that \$10,000 of the amount paid to each taxpayer as salary, and about \$1000 in life insurance premiums paid for him were excessive, and same were disallowed as deductions therein. Other determinations affecting the corporate returns in prior years were made, resulting in tax deficiencies. In 1947 and 1948 Hartfield

and Healy each paid to the Collector direct, or through the corporation, a total of about \$7,000 to satisfy the balance of the deficiencies due from the corporation. The determinations of the Commissioner above referred to, the insolvency of the corporation, and the liability of respondents as transferees in the amounts paid are not disputed."

The Tax Court of the United States determined that the facts were almost identical with the facts in *Hall C. Smith*, 11 T. C. 174 and that the *Smith* case governed the present proceedings. The basis of the Tax Court's determination in the *Smith* case was that the excessive compensation received by Smith was impressed with a trust from the time of receipt and therefore subject to a legal restriction on its use. Petition for review to the United States Court of Appeals for the Second Circuit was filed by the respondent. The Court of Appeals reversed the Tax Court of the United States, deciding that the excessive compensation was received under a claim of right and without restriction as to its disposition.

The petitioners contended before the Court of Appeals that the excessive compensation was not taxable under the trust fund doctrine, also that Section 15 of the Stock Corporation Law of New York makes void the payment of excessive compensation by an insolvent corporation. The Court of Appeals decided that said Section 15 was not applicable.

Questions Presented

Did that portion of compensation received by the petitioners from an insolvent corporation in 1945 and used by them in 1947 and 1948 to satisfy tax deficiencies of the insolvent corporation constitute income to them in the year of receipt where in a later year, it was agreed that the compensation was excessive and accordingly was disallowed as a deduction to the corporation?

Does Section 15 of the Stock Corporation Law of New York render receipt of excessive compensation paid by an insolvent corporation to its officers non-taxable to the recipient?

Reasons for Allowance of the Writ of Certiorari

The United States Court of Appeals for the Second Circuit, in the present cases, has rendered a decision in direct conflict with the decision of the United States Court of Appeals in *Commissioner of Internal Revenue v. Hall C. Smith*, 6 Cir. 194 F. 2d 536. Motion for rehearing denied. This decision affirmed the Tax Court of the United States in *Hall C. Smith*, 11 T.C. 174, relying on *Commissioner v. Wilcox*, 327 U. S. 404. The Tax Court, in the present cases, stated

"The facts herein are almost identical with those in *Hall C. Smith*, 11 T. C. 174, and we believe that case governs the instant proceedings."

The denial for rehearing by the Court of Appeals for the Sixth Circuit was made after the decision by the Court of Appeals for the Second Circuit and although respondent's papers on the motion for rehearing are not available it must be assumed that the decision of the Second Circuit was brought to the attention of the Court of Appeals for the Sixth Circuit.

In the present state of the decisions in the two Circuits it is clear that a different answer will be reached by each Circuit on the same set of facts.

There is a question of federal law which would seem to be important enough to warrant examination by this Court. There still is uncertainty about the application of the claim of right doctrine enunciated in *North American Oil v. Burnet*, 286 U. S. 417. A determination by this Court in the present cases would remove much of the uncertainty and

settle a conflict between the Second and Sixth Circuits of the Court of Appeals.

WHEREFORE it is respectfully requested that this petition for writ of certiorari to review the judgment of the Court of Appeals for the Second Circuit should be granted.

EDWIN E. HEALY,
GORDON W. HARTFIELD,
By FRANK J. MAGUIRE,
Attorney for Petitioners.

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Supreme Court of the United States

OCTOBER TERM, 1952

No. 76

EDWIN E. HEALY and GORDON W. HARTFIELD,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF
APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' BRIEF

Petition for Certiorari Filed May 20, 1952

Certiorari Granted October 13, 1952

JAMES H. HEFFERN,
1300 Genesee Building,
Buffalo, New York,
Counsel for Petitioners.

BRIEF IN SUPPORT OF THE PETITION

Opinions Below

The opinion of the Tax Court of the United States in this proceeding was promulgated on January 26, 1951. It is reported at 16 T. C. 200, and is printed on pages 9, 10, 11, 12 and 13 of the Record.

The opinion of the United States Court of Appeals for the Second Circuit is reported at 194 F. 2d 662 and is printed on pages 15, 16, and 17 of the Record.

Jurisdiction

The grounds on which jurisdiction of this Court is invoked are set forth in the Petition at pages 4 and 5 thereof.

Statement of the Case

The Statement of the Case appears in the Petition at pages 2 and 3 and is not repeated here.

Specification of Errors

The Court of Appeals for the Second Circuit erred:

In holding that petitioners received the excessive compensation under a claim of right and without restrictions as to its disposition.

In holding that Section 15 of the Stock Corporation Law of New York was not applicable to the present facts.

Statutes Involved

The pertinent provisions of the Internal Revenue Code and of the Treasury Department Regulations and Section 15 of the Stock Corporation Law of New York are printed at the end of this Brief.

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Argument

THE AMOUNTS OF EXCESSIVE COMPENSATION RECEIVED BY PETITIONERS AND USED TO SATISFY THE TAX LIABILITY OF HARTFIELD-HEALY SUPPLY CO., INC. WERE NOT RECEIVED UNDER A CLAIM OF RIGHT AND WITHOUT RESTRICTIONS AS TO THEIR USE.

The Tax Court of the United States determined that the petitioners received the excessive compensation impressed with a trust from the time of their receipt. The Court of Appeals in reversing the Tax Court stated at page 663:

"There would seem to be no question here that the respondents received their 1945 salaries from the corporation under a claim of right, and without restrictions as to their disposition, which is the test outlined in the North American Oil case. The fact that such salaries were reported on the individual tax returns as earnings or income would seem to be determinative of that question."

This holding, applied to the facts in *Commissioner v. Smith*, 6 Cir., 194 F. 2d 536 would have produced the exact opposite of the actual result in that case. The Tax Court in the present cases relied almost entirely on its decision in *Smith v. Commissioner*, 11 T. C. 64. The Sixth Circuit affirmed the Tax Court and the Second Circuit reversed the Tax Court, resulting in a direct conflict.

It is submitted that the Second Circuit has oversimplified the claim of right doctrine. Under its reasoning the embezzler in *Commissioner v. Wilcox*, 327 U. S. 404, 90 L. Ed. 752, 66 S. Ct. 546 would have been taxed on the embezzled money had he reported it on his income tax return. It seems to the petitioners that claim of right necessarily presupposes at least some semblance of beneficial title. It does not seem that claim of right can be based solely on the claimant's intent or state of mind.

The United States Court of Appeals for the Sixth Circuit in *Commissioner v. Smith, supra*, said

"And it appearing that the receipt of the excessive salary to the extent of which the respondent was held liable as transferee constituted 'the bare receipt of property or money wholly belonging to another,' *Commissioner of Internal Revenue v. Wilcox*, 327 U. S. 404, 66 S. Ct. 546, 549, 90 L. Ed. 752 and that the respondent held the funds not for himself but for the creditors of the transferor;"

The fact that petitioners reported the excessive compensation indicates that they claim the compensation as their own but the claim of right doctrine has two sides, one the claim and the other freedom from restrictions as to use. At the time the compensation was paid by Hartfield-Healy Supply Co., Inc. it was insolvent and its Balance Sheet showed Accrued Federal Income Taxes of \$7,888.35 (R. 6). At least to that extent there was a restriction as to the use of the excessive compensation.

Petitioners believe, and feel that both the Second Circuit and the respondent would agree with their belief, that the real question in these cases is whether or not there was any transferee liability existing on December 31, 1945. Or in other words was the existence of excessive compensation a fact on December 31, 1945. Bearing in mind that the determination of the respondent was not contested, petitioners fail to perceive how or why the determination was a "later fact" as the Second Circuit held. The excessive compensation was a fact when paid, its discovery may have come in a later year, but it existed as a fact when payment was made. The respondent, in the present cases, merely ascertained a fact already in existence. His uncontested determination is not a later fact which changed the nature of the original payment.

Therefore, if payment of excessive compensation was a

fact in 1945, and petitioners submit it could not have been otherwise, a transferee liability existed in 1945 and the compensation in question was under a definite restriction, at least to the extent of the tax liability existing at December 31, 1945.

SECTION 15 OF THE STOCK CORPORATION LAW AFFECTS THE FEDERAL TAXATION OF INCOME SINCE IT RENDERS VOID CERTAIN PROHIBITED TRANSACTIONS.

The Court of Appeals for the Second Circuit in its opinion at page 663 states:

"Section 15 of the ~~S~~tock Corporation Law of the State of New York is not applicable here. If it has any bearing on a question of federal taxation, we are not persuaded that it would override the legal principle above referred to. In any event it would apply only in case of payments made with the intent of giving a preference to creditors. Such intent must exist or be established to invoke the statute and to establish a liability upon the recipient. The contention lacks a factual basis. *New York Credit Men's Association v. Hasenberg*, D. C., 26 F. Supp. 877; affirmed 2 Cir., 107 F. 2d 1026, per curiam."

Petitioners believe that the cited case is authority only for the principle that an officer or director who is *not a transferee* must have an intent to create a preference. Common sense should dictate that an officer of an insolvent corporation who transfers property to himself must be held to have received it in trust, *regardless of his intent*. In any event the officer, transferee in the cited case, was one of the defendants against whom a judgment was rendered, in the full amount of the transferred property.

Section 15 of the Stock Corporation Law of New York is printed at page 12 of this Brief. That section provides that a transfer in violation of it "shall be void". The

section is an extension of the trust fund doctrine, creating a statutory prohibition against the payment of excessive compensation to an officer by an insolvent corporation. Therefore the petitioners contend that the New York statute can and does have an effect on the federal taxation of income. The petitioners here, as in *Commissioner v. Wilcox, supra*, were at all times under an unqualified duty and obligation to repay the excessive compensation. The very transfer was void, *not* a mistake as in *U. S. v. Lewis*, 340 U. S. 590, and *not* subject to litigation as in *North American Oil v. Burnet*, 286 U. S. 417.

Finally, the petitioners point out that these are specific cases of *admittedly* excessive compensation paid by an *insolvent* corporation where the compensation went to satisfy a transferee liability.

Conclusion

The decision below is incorrect and in conflict with the decision of the Sixth Circuit in *Commissioner v. Smith*, 194 F. 2d 536. The question is of sufficient importance that the petition for writ of certiorari should be granted.

Respectfully submitted,

FRANK J. MAGUIRE,
Attorney for Petitioners.

APPENDIX

STATUTES INVOLVED

Internal Revenue Code:

Sec. 22. Gross Income.

(a) General Definition. "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, . . . also from . . . dividends . . .

(26 U. S. C. 1946 ed., Sec. 22)

Sec. 42 (As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687). Period in which items of gross income included.

(a) General Rule. The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period. . . .

(26 U. S. C. 1946 ed., Sec. 42)

Sec. 311. Transferred Assets.

(a) Method of Collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) Transferees. The liability, at law or in equity, of a transferee of property of a taxpayer in respect of the tax (including interest, additional amounts, and additions to the

tax provided by law) imposed upon the taxpayer by this chapter.

(26-U. S. C. 1946 ed., Sec. 311)

Section 15. New York Stock-Corporation Law.

§15. Prohibited transfers to officers, stockholders, directors or creditors. No corporation which shall have refused to pay any of its notes or other obligations, when due, in lawful money of the United States, nor any of its officers or directors, shall transfer any of its property to any of its officers, directors or stockholders, directly or indirectly for the payment of any debt, or upon any other consideration than the full value of the property paid in cash. No conveyance, assignment or transfer of any property of any such corporation by it or by any officer, director or stockholder thereof, nor any payment made, judgment suffered, lien created or security given by it or by any officer, director or stockholder when the corporation is insolvent or its insolvency is imminent, with the intent of giving a preference to any particular creditor over other creditors of the corporation, shall be valid, except as to any rights or interests which may be acquired thereunder by any person without notice or reasonable cause to believe that such conveyance, assignment, transfer, payment, judgment, lien or security would effect a preference, and except also that laborers' wages for services shall be preferred claims and be entitled to payment before any other creditors out of the corporation assets in excess of valid prior liens or incumbrances. No corporation formed under or subject to the banking, insurance or railroad law shall make any assignment in contemplation of insolvency. Every person receiving by means of any such prohibited act or deed any property of a corporation shall be bound to account therefor to its creditors or stockholders or other trustees. No stockholder of any corporation shall make any transfer or assignment of his stock therein to any person in contemplation of its insolvency. Every transfer or assignment or other act done in violation of the foregoing provisions of this section shall be void, except as hereinbefore provided.

Every director or officer of a corporation who shall be concerned in the making of any conveyance, assignment, transfer or payment, the suffering of any judgment or the creation of any lien or the giving of any security by such corporation when it is insolvent or its insolvency is imminent, with the intent of giving a preference to any particular creditor over any of the other creditors of the corporation or who shall violate or be concerned in violating any other provision of this section, shall be personally liable to the creditors and stockholders of the corporation of which he shall be director or an officer to the full extent of any loss they may respectively sustain by such violation.

(1851)